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April 23, 2001

Ex Parte Presentation

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

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**FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY**

*Re: Application by Southwestern Bell for Provision of In-Region,
InterLATA Services in Missouri, CC Docket No. 01-88*

Dear Ms. Salas:

On behalf of Southwestern Bell Telephone Company ("SWBT") and at the request of the Competitive Pricing Division of the Common Carrier Bureau, I am submitting a CD containing confidential cost material in five separate files – four in Microsoft Excel format and one in Microsoft Word format. The following files are included:

- (1) "Missouri Loop Costs" spreadsheet – an Excel file that replicates the results of the Automated Cost Extraction System ("ACES"), a mainframe study that was used in 1997 in Missouri (but which is no longer in use) to compute recurring monthly capital costs and operating expenses based on plant investments for network elements;
- (2) "MO 1997 Inputs" spreadsheet – an Excel file that contains all the loop investments (including the Missouri PSC's Staff modifications) that were used to carry out the 1997 LPVST cost study (which is no longer in use);
- (3) "Missouri 96ACF" spreadsheet – an Excel file that lists the 1996 annual cost factors by account and that incorporates the Missouri PSC Staff's modifications;
- (4) "CAPCS MO Case TO-97-40" spreadsheet – an Excel file consisting of the Capital Cost System calculation worksheets and incorporating the inputs that

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were used to calculate the capital cost factors in 1997 using the old CAPCOST model that is no longer in use; and

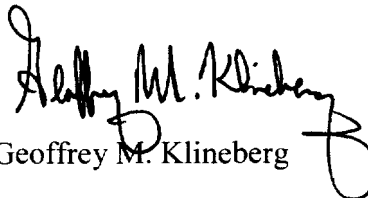
- (5) "CAPCS Documentation" – a Word file consisting of the CAPCS User Manual Documentation.

In addition to the confidential material described above, I am attaching a three-page document that provides a brief overview of the CAPCS methodology.

Pursuant to the Commission's rules governing confidential ex parte communications, I am enclosing one original copy of the attached CD. Inquiries regarding access to the confidential material submitted with this letter should be addressed to Kevin Walker, Kellogg, Huber, Hansen, Todd & Evans, PLLC, 1615 M Street, N.W., Suite 400, Washington, D.C., 20036, (202) 367-7820.

I am also enclosing an original and two copies of this letter labeled Redacted for Public Inspection, together with the public attachment. Please file stamp and return the additional copy. Thank you for your assistance in this matter.

Sincerely,


Geoffrey M. Klineberg

Attachments

cc: Tom Navin
Richard Lerner
Gary Remondino
Layla Seirafi
Dan Joyce
ITS (Redacted Version Only w/o CD Attachment)

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SBC Telecommunications, Inc.
Capital Cost Factors
Description of CAPCS
1999

The Capital Cost System (CAPCS) is used by SBC Telecommunications, Inc. to calculate capital costs attributable to telephone plant. Capital costs consist of three components - depreciation, cost of money and income taxes.

Capital costs are computed for each telephone plant account and several sub-accounts based upon user-provided cost data.¹ These include, for example, plant service lives, survivor curves, salvage values and others. Capital costs typically are calculated in cost studies by applying an annual capital cost to estimates of the investment in telephone plant. Capital cost factors are "levelized" values reflecting a time value of money-weighted, average cost over a future planning period. The planning period may be the full life of the plant or a shorter planning period specified by the cost analyst.

Depreciation

Book depreciation is the annual expense of recovering capital invested in telephone plant over the service life of the plant. Expenditures for materials, engineering, labor and other costs of plant construction which is expected to have a service life of more than one year are "capitalized." These costs are recovered over the plant's life rather than being expensed in the year in which the plant enters service.

Service life is the number of years plant is in service. Future service lives are based on estimates of how long plant will be "used and useful." Factors that affect plant service lives include wear, damage, technological obsolescence and others.

As capital invested in telephone plant is recovered, depreciation is accrued in a depreciation reserve. When plant is retired, the plant and depreciation reserve accounts are reduced by the value of the initial investment. The plant investment is fully recovered if the annual rate of depreciation is consistent with the service life and salvage realized when the plant is retired.

¹ Plant accounts are defined in the Uniform System of Accounts, Part 32 of the FCC Rules.

The initial investment, net salvage and service life² of the plant determine book depreciation.³ Book depreciation typically is calculated using straight-line depreciation based on the following formula:

$$\text{Book depreciation} = (\text{Initial investment} - \text{Net salvage}) / \text{Service life}.$$

$$\text{Net salvage} = \text{Gross salvage} - \text{Cost of removal}.$$

Telephone plant is normally placed in vintages of plant, representing groups of plant of the same type (switching systems, cable facilities, etc.) placed in the same year. Individual items of plant within a vintage usually have different service lives, with the vintage having an average service life for all plant placed in the vintage year. Most telephone companies use depreciation methods that recognize “vintage group accounting” and average service lives. The method commonly used today is called Equal Life Group (ELG) depreciation. CAPCS uses ELG depreciation.⁴

Cost of Money

Each year of the plant’s service life, a portion of the initial investment is recovered from revenues, and depreciation accrues to the depreciation reserve. In any year, the difference between the initial investment and the depreciation reserve represents the capital investment remaining to be recovered. This is referred to as net investment. SBC Telecommunications, Inc. must earn sufficient revenues in excess of operating expenses, including depreciation expense, to provide a return on investor capital (debt and equity). This required return or cost of money is computed by applying a cost of money rate to the net investment.

$$\text{Cost of Money} = \text{Cost of Money (\%)} \times \text{Net Investment}.$$

$$\text{Net Investment} = \text{Initial Investment} - \text{Depreciation Reserve}.$$

$$\text{Cost of Money (\%)} = \text{Debt Ratio} \times \text{Cost of Debt (\%)} + (1 - \text{Debt Ratio}) \times \text{Cost of Equity (\%)}.$$

² In forward-looking, incremental cost studies, service life also is referred to as the *economic life* of plant.

³ The survivor curve or percentage of original plant investment remaining in service each year also affects depreciation expense for the Equal Life Group depreciation method.

⁴ Another method is Vintage Group (VG) depreciation. The SBC telephone companies currently use ELG depreciation, rather than VG depreciation.

Income Taxes

Federal and state governments impose taxes on income after allowable tax deductions. Tax deductions generally include operating expenses, tax depreciation and others. In cost studies, income taxes represent the taxes that would be paid by the Company on income before taxes sufficient to cover the cost of equity. In other words, for a service to produce revenue sufficient to cover the cost of equity, it is necessary to “gross-up” the cost of equity for income taxes.

Required pre-tax income = Cost of equity / (1 - Effective income tax rate).

Income taxes = Effective income tax rate X Required pre-tax income.

The effective income tax rate is a composite rate for federal and state income taxes.